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In the Supreme Court of the United States

OCTOBER TERM, 1940

No. ——

UNITED STATES OF AMERICA, PETITIONER

v.

BETHLEHEM STEEL CORPORATION, BETHLEHEM SHIPBUILDING CORPORATION, LTD., BETHLEHEM STEEL COMPANY, FORE RIVER SHIPBUILDING CORPORATION, UNION IRON WORKS COMPANY

No. ——

UNITED STATES SHIPPING BOARD MERCHANT FLEET CORPORATION, PETITIONER

v.

BETHLEHEM SHIPBUILDING CORPORATION, LTD.

PETITION FOR WRITS OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT

The Solicitor General, on behalf of the United States and the United States Shipping Board Merchant Fleet Corporation, prays that writs of certiorari be issued to review the judgments of the United States Circuit Court of Appeals for the Third Circuit entered in the above-entitled causes on June 18, 1940.

OPINIONS BELOW

The opinions of the United States District Court for the Eastern District of Pennsylvania (R. 733, 749, 752) are reported in part in 23 F. Supp. 676 and 26 F. Supp. 259. The opinion of the United States Circuit Court of Appeals for the Third Circuit (R. 2323–2332) has not yet been reported.

JURISDICTION

The judgments of the United States Circuit Court of Appeals for the Third Circuit was entered on June 18, 1940 (R. 2333). The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTIONS PRESENTED

During the World War, the Fleet Corporation entered into contracts with respondents for the construction of a number of ships. The contracts provided for the payment of the cost of constructing the ships, plus a fixed profit, plus a fee (known as a "bonus for savings") equal to one-half the amount by which the actual cost of the ships might be less than a stated estimate of cost. The estimated cost of all the vessels was about $120,000,000; the actual cost was about $93,000,000; respondents' profits under the contracts would be over $25,000,000. The questions are:

1. Whether the contracts are unconscionable because of the circumstances in which they were

negotiated and the aggregate profit which accrued to respondents.

2. Whether respondents are entitled to a "bonus for savings" in the absence of any proof that this provision of the contracts led to any reduction in cost.

3. Whether the "bonus for savings" provision, if it operates in the absence of any real reduction in cost, is invalid as opposed to public policy; and whether the execution of contracts containing this provision as so construed was within the authority of the Fleet Corporation officials.

STATEMENT

The proceedings.—These two cases involve substantially the same questions. One is a suit in equity brought by the United States against Bethlehem Steel Corporation and certain subsidiary companies for an accounting and the recovery of sums paid to the defendants, or some of them, without authority of law, under certain contracts to build ships for the United States, represented by the United States Shipping Board Emergency Fleet Corporation (herein called the "Fleet Corporation").[1] The other is an action at law brought against the Fleet Corporation by Bethlehem Ship-

[1] The name of the Fleet Corporation was subsequently changed to United States Shipping Board Merchant Fleet Corporation and the caption of the action at law appropriately changed (R. 746).

building Corporation, Ltd. (herein called "Bethlehem"), a wholly owned subsidiary of Bethlehem Steel Corporation (R. 525), to recover the sum of $7,691,400.14 claimed by Bethlehem under the aforesaid contracts, as unpaid "bonus for savings."

Trial by jury in the law case was waived (R. 509), and both cases were referred to a Special Master and Referee for hearing (R. 509, 513, 2306, 2309, 2310). The successor to the original Special Master and Referee, after making findings of fact and conclusions of law (R. 515–692), recommended the dismissal of the Government's bill in the equity suit, and of Bethlehem's counterclaims thereto; and in the law case recommended that judgment be entered for $5,272,075.10 in favor of Bethlehem against the Fleet Corporation (R. 560–566).

The District Court approved and confirmed the Master's report and findings, dismissed the bill in the equity suit and Bethlehem's counterclaim thereto (R. 2311), and in the law case entered judgment in the amount recommended by the Master (R. 760).[2] The Circuit Court of Appeals affirmed the judgments (R. 2333).

The facts.—In 1917 the war emergency required the United States to requisition all ships suitable

[2] Bethlehem claimed interest at six percent from specified dates; the Master recommended interest at two percent; and the District Court entered judgment without interest. In the law case, Bethlehem appealed on this issue to the Circuit Court of Appeals, which upheld the lower court's decision. (R. 563–566, 742–744, 749–751, 2330–2332.) This point is not involved in the present petition.

for war purposes which were then under construction, and to build as many vessels as possible in the shortest period of time (R. 539, 574–5). To attain these objectives, it was necessary to obtain the cooperation of and to place contracts with Bethlehem, the largest shipbuilding concern in the world (R. 539, 574). There was no feasible alternative to the awarding of contracts to Bethlehem (R. 539). These emergency needs were well known to Bethlehem and its agents (R. 575).

Late in 1917, negotiations were entered into between Bethlehem and the Fleet Corporation. Bethlehem was represented by two exceptionally competent shipbuilders, Powell and Brown. Charles Piez, vice-president and general manager of the Fleet Corporation, had exclusive authority to negotiate its contracts. The actual negotiations were conducted for the Fleet Corporation by Bowles and Radford, shipbuilding experts said by the Master to be as able as those of Bethlehem. (R. 527, 575–577.) Piez was a business executive of long experience but was without any shipbuilding experience (R. 527, 646). The Master found that the negotiations were conducted at arm's length (R. 529); he also found that Piez and Powell were "very close," and that Piez had "implicit confidence in Powell's integrity" and "was accustomed to look to him for information and assistance" in shipbuilding matters (R. 646).

At the time of the negotiations it was impracticable to estimate the cost of construction within

a reasonable percentage (R. 530). Yet Bethlehem was in a much better position to make an estimate than was the Fleet Corporation. Except for seven of the smaller cargo ships, all of the vessels covered by the contracts in controversy were Bethlehem's standard types of ships, being duplicates of or substantially similar to ships which had been recently constructed at its shipyards, and which were under construction at the time of the negotiations (R. 591–594). This experience gave Bethlehem a mass of cost data, so that at the time of the negotiations it was in a position to determine the cost of constructing similar ships in the past (R. 594–597, 613–614). It was contemplated that the efficiency of labor would be considerably increased by the fact that the ships to be built were of but few types and were similar to Bethlehem's standard types of ships (R. 608). The Fleet Corporation's position was wholly different. It was entirely without information as to costs except for the general experience of its negotiators (R. 618–623) and it presented no estimates of its own at any time (R. 644).

Throughout the course of these negotiations the Fleet Corporation made repeated but unsuccessful efforts to enter into "lump sum" contracts (R. 626–627). Bethlehem, however, insisted upon its "bonus-for-savings" form of contract, and would not undertake construction under any other type of contract (R. 627, 642–643, 738). These con-

tracts[3] provided that the price paid Bethlehem should be (1) the actual cost of construction, plus (2) a fixed profit, amounting to about 10 per cent of the estimated cost, plus (3) the "bonus for savings," equal to one-half of the amount by which the actual cost fell below the estimated cost (*e. g.*, R. 117–118; cf. R. 572). Under these contracts, then, Bethlehem took no risk of any loss and was assured a profit of about 10 per cent of the estimated cost; in addition it would receive 50 per cent of the amount by which the actual cost should be less than the estimated cost.

It was understood that Bethlehem's participation in the "savings" bonus was supposed to represent "consideration for its special efforts and ability to reduce cost by increasing efficiency of management and labor as compared with efficiency then existing" (R. 638), although the negotiators understood that there might be additional factors which might result in "savings" (R. 636–637).

The estimates of cost, crucial in fixing the extent of Bethlehem's profits under these contracts, were prepared by Bethlehem alone (R. 643–644). The estimates as prepared by Brown were shown in these proceedings to have contained large allowances for (a) decrease in efficiency (R. 1856); (b)

[3] The vessels were constructed under 13 substantially identical contracts—Nos. S. C. 183, 184, 299, 314, 178, 196, 226, 300, 191, 230, 177, 301, 179 (R. 1966). Copies of these contracts may be found at R. 109–146, 158–258, 270–282, 2089–2114.

increase in freight rates and delivery cost (R. 1855); (c) increase in prices of materials (R. 611, 631); and (d) extraordinary contingencies (R. 1857).[4] The resulting figures Powell substantially increased prior to the Fleet Corporation negotiations, as he admitted, "for trading purposes" (R. 672). Yet Powell and Brown represented that, in "their best and mature judgment," the estimates submitted by Bethlehem were the lowest which would afford Bethlehem a reasonable opportunity to effect savings as a result of increased efficiency of management and labor (R. 639–640), that they were "fair and reasonable" (R. 643), and that they were about as accurate as could be arrived at in the circumstances (R. 644).

The bases upon which these estimates had been made up were not revealed to the Fleet Corporation (R. 672). The only break-down of the costs of the various types of ships offered on Bethlehem's behalf during the negotiations was represented to be "based upon a close study of the facts affecting cost" (R. 585), but the Master found it represented merely "an arbitrary division of the total cost estimates" and that it was "submitted for the purpose of lending a semblance of support to such estimates" (R. 641).

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[4] The extent of these allowances is suggested by the fact that it was assumed that wage rates would increase by 29 percent, that there would be a 30 percent *decrease* in efficiency, that freight rates would increase by 42 percent, and that a flat 10 percent of the total cost should be added to cover contingencies (R. 1855–1857).

The Master, however, also found that the representatives of the Fleet Corporation had knowledge, or information available from which knowledge could have been obtained, by which they could judge of the reasonableness of the estimated base price for the ships (R. 538). He further found that "the estimated base costs used in the contracts represented reasonable estimates of probable cost" (R. 688) and that Bethlehem had been guilty of no fraud or misrepresentation during the negotiations (R. 556).

The representatives of the Fleet Corporation knew that the prices demanded by Bethlehem, even though less than those originally asked, were high and that Bethlehem hoped to make a substantial profit from the transaction (R. 529, 531). The prices finally set were the lowest which Bethlehem would agree to take and were accepted by the representatives of the Fleet Corporation as the best that could be obtained "under very difficult conditions" (R. 528, 646). It was felt that Bethlehem's organization was necessary to assure the success of the Fleet Corporation's shipbuilding program (R. 531, 539), and consequently the representatives of the Fleet Corporation entered into the contracts, although resenting the commercial attitude of Bethlehem and condemning Bethlehem for demanding its "pound of flesh" (R. 539).

Actual construction proved that the estimated cost was inordinately high. The total estimated cos ..ad been fixed at $119,750,000, while the actual

base cost turned out to be $92,990,520.91, a difference of $26,759,479.09 (R. 572). For this discrepancy between estimate and actuality Bethlehem offered neither justification nor explanation (R. 674). There is, as the Master found, "no evidence that the cost of construction of the respective tank and cargo ships in controversy was reduced as a result of the 'bonus-for-savings' provisions of the respective contracts" (R. 678).*

Bethlehem has already received the total cost (including the cost of "extras") and, in addition $11,962,400 as fixed profits and $8,093,156.60 as a bonus for savings, or total profits of $20,055,556.60 (R. 1642–1721). In these suits, more than $7,500,000 additional profits were asked for and judgment was awarded for $5,272,075.10. Bethlehem, which assumed no risk of loss, has thus been awarded profits amounting to $25,327,631.70, representing an average profit on the contracts of 27 percent of the actual base cost and 23 percent of the actual costs including extra work (R. 572; cf. R. 554). This figure does not take into account any profits made by Bethlehem Steel Company, an affiliate, on the sales to Bethlehem of substantial amounts of

* The statement of the Circuit Court of Appeals (R. 2330) that "the record contains some evidence tending to show that the savings resulted, in part at least, from increased efficiency" is directly contrary to this finding of the Master, approved by the District Court. The Court of Appeals does not indicate the nature or the extent of any such savings.

materials used in the construction of the vessels (R. 604).

SPECIFICATION OF ERRORS TO BE URGED

The Circuit Court of Appeals for the Third Circuit erred:

1. In holding that the "bonus for savings" provisions required that the bonus be paid regardless of the existence of savings due to increased efficiency.

2. In failing to hold the "bonus for savings" provisions of the contracts, as those provisions were construed by it, invalid and unenforceable for want of consideration and failure of performance.

3. In failing to hold that there is no evidence that any savings resulted from increased efficiency or unusual effort due to the "bonus for savings" provisions.

4. In failing to hold that, as construed by it, and in the circumstances revealed by these cases, the "bonus for savings" provisions were unenforceable and invalid as contrary to public policy.

5. In failing to hold that, in the circumstances under which these contracts were executed, the profits made by Bethlehem were so inordinate and unconscionable as to bar recovery by respondents of any further profits, and to require respondents to account for excessive profits already received.

6. In failing to hold that, if the contracts are to be construed as the court below has construed them, and are enforceable as so construed, the officials of

the Fleet Corporation had no authority to enter into such contracts, and it was a breach of their fiduciary duty to do so.

7. In affirming the judgments of the District Court.

REASONS FOR GRANTING THE WRITS

Nothing less than a decision of this Court should be allowed to settle the doctrine that a court of equity is forced without flinching to apply the harshest rules of a free market, where the buyer need only choose among competing sellers, to transactions such as these. In times of national emergency the men charged with preparing the nation's defenses have no time for haggling with a contractor who refuses to perform his indispensable functions unless he be assured an exorbitant profit. The Government is now engaged in a program of military and naval armament comparable to or greater than that undertaken in 1917 and 1918.[6] It

[6] Public, No. 703, 76th Cong., 3d Sess., c. 508, approved July 2, 1940 (An Act to expedite the strengthening of the national defense); Public, No. 671, c. 440, approved June 28, 1940 (An Act to expedite the national defense); Public, No. 426, c. 44, approved March 5, 1940 (An Act to facilitate the procurement of aircraft for the national defense); Public, No. 635, c. 375, approved June 15, 1940 (An Act to authorize the construction or acquisition of naval aircraft); Public, No. 664, c. 427, approved June 25, 1940 (An Act to amend the Reconstruction Finance Corporation Act, etc.); Public, No. 629, c. 364, approved June 14, 1940 (An Act to establish the composition of the United States Navy, to authorize the construction of certain naval vessels, etc.); Public Res. No. 83, c. 365, approved June 15, 1940 (To authorize assistance

is therefore, of immediate national concern that there should be an authoritative determination of the extent to which the country's need should place the Government at the mercy of its contractors.

1. Both of the courts below, although rejecting the charges of actual fraud and misrepresentation, clearly recognized that Bethlehem had deliberately insisted upon the "bonus-for-savings" clause and upon the swollen estimates finally adopted, that the Government had no choice but to accept, and that the profits made were extraordinary. The District Court stigmatized Bethlehem as adopting a "take it or leave it" attitude, and thought its actions constituted "daylight robbery"; it found an

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to the governments of American republics to increase their military and naval establishments); Public, No. 588, c. 313, approved June 11, 1940 (Navy Department Appropriation Act, 1941); Public, No. 611, c. 343, approved June 13, 1940 (Military Appropriation Act, 1941); Public, No. 667, c. 430, approved June 26, 1940 (First Supplemental National Defense Appropriation Act, 1941); Public, No. 656, c. 419, approved June 25, 1940 (Revenue Act of 1940, to provide for the expenses of national preparedness).

See also Proclamation by the President, of September 8, 1939, proclaiming a national emergency in connection with the observances, safeguarding, and enforcement of neutrality and the strengthening of the national defense, 4 Fed. Reg. 3851; Executive Order setting up the Office for Emergency Management in the Executive Offices, 5 Fed. Reg. 2109; the Rules and Regulations of the revived Council on National Defense, 5 Fed. Reg. 2114; the establishment of an Advisory Commission to the Council, 5 Fed. Reg. 2114, 2381; the establishment of a National Defense Research Committee, and of a Coordinator of National Defense Purchases, 5 Fed. Reg. 2446.

analogy in "the famous Rob Roy distinction who admitted he was a robber but proudly proclaimed that he was no thief" (R. 738; see also R. 736, 741). In the view of the Circuit Court of Appeals, Bethlehem's insistence upon the extraordinary margin of profit it obtained indicated "an attitude of commercial greed but little diluted with patriotic feeling" (R. 2327); the court observed that "it can hardly be denied that Bethlehem took advantage of the war emergency to drive a hard bargain," and that "Bethlehem may be condemned for having taken advantage of the Nation's necessities to secure inordinate profits" (R. 2328). Both courts agreed that the Fleet Corporation had no real freedom to reject Bethlehem's harsh terms (R. 738, 741, 2328).

Nevertheless, both courts refused to hold the results of enforcing the contracts unconscionable. The Circuit Court of Appeals felt that since the Fleet Corporation was aware how large Bethlehem's estimates were, the contracts could not be held so extortionate as to be unenforceable. But there is no evidence in the record that the Fleet Corporation's officials had any inkling of the extent to which Bethlehem's estimates were inflated or of the exorbitant profits which respondents would make. In any case the criterion is not the extent of the delusion but rather the grossness of the extortion. We cannot agree that the law sanctions, as obtained in good conscience, profits amounting

to more than 27 per cent of the cost of constructing the vessels under the contracts, when those profits were secured without the slightest risk of loss, provided an assured gain of about ten per cent of the estimated cost, and were coerced by the threat of withholding an essential service from the Government in wartime.

The courts have long since fashioned qualifications to the ordinary rules of contract law which are embodied in the familiar principles of duress, incapacity, and unjust enrichment. Those principles have full application to circumstances such as these, either within the technical confines of textbook law or as illustrative of the more basic principle that, when the bargain was not freely made by one with an option to refuse, a court will enforce the contract according to its justice and not according to its terms.

This Court has held, in *Hume* v. *United States*, 132 U. S. 406, that a contract may not be enforced against the Government, even in the absence of actual fraud, when the price demanded is unconscionable. And in *Burke & James, Inc.* v. *United States*, 63 C. Cls. 36, the court refused to enforce a wartime "bonus-for-savings" contract which, like those of respondents, resulted in inordinate profits to the contractor.

The Master and the Circuit Court of Appeals each emphasized that similar excessive profits were made on other contracts (R. 546–551, 2328–2329).

This comparison of excessive profits is misleading and incomplete.* But, in any event, we do not understand that unconscionable profits become acceptable to a court of equity because the necessities of the Government led to repeated instead of sporadic extortion.

2. Even if the contracts were not unconscionable, respondents have wholly failed in the promised performance which was the consideration for which the United States bargained in agreeing to the "bonus for savings" provision. The clause should, as a matter of law, be interpreted to award a bonus only if savings beneficial to the United States are actually made. The purpose of the provision could

*The Master relied on six war contracts (apparently later contracts with Bethlehem) and three peacetime contracts where comparable or greater profits had been received (R. 549–551, 554). He did not specify whether these contracts were lump-sum contracts, involving a risk of loss, or cost-plus or "bonus-for-savings" contracts. The record, on the other hand, shows that 10 percent of the actual cost was considered a reasonable profit in wartime (R. 654–656). Indeed, Mr. Schwab, as Director-General of the Fleet Corporation, forced another shipbuilding concern to modify existing contracts so that no profit of more than 10 percent could be earned (R. 660–662); this, he hoped, would "prove an object lesson to any other contractors who think that they can take advantage of us to obtain excessive prices for ships" (R. 662). And, at about the same time the contracts in question were negotiated, Bethlehem agreed with the Fleet Corporation to construct two troop ships on a cost-plus basis for a profit of 10 percent of actual cost (R. 654–655). Bethlehem's fixed fees alone, under the contracts here involved, were appreciably in excess of 10 percent of actual cost (R. 572).

not have been, as the District Court thought, "an agreement to pay something for nothing" (R. 741), or to reward the respondents for their inability to estimate construction costs accurately, or to supply an incentive to inflate the cost estimates. The obvious intention was to spur respondents to the extra effort and increased efficiency necessary to reduce the cost of the vessels below the figure which a "cost plus" contract would attain.[8] In fact, however, the difference between the estimated cost of construction and the actual cost did not result from Bethlehem's increasing its efficiency (R. 678). Respondents, having thus failed in their performance, are entitled neither to receive any further bonus nor to retain the bonus already paid.

The decision below, rejecting these views, is in direct conflict with the decision of the Court of Claims in *Burke & James, Inc.*, v. *United States*, 63 C. Cls. 36, which held that the "bonus-for-savings" provisions in war contracts are severable as a matter of law, and that the bonus is payable only in the event of savings realized through substantially increased efficiency.[9] *J. J. Preis & Co.* v.

[8] This was the real understanding of the parties, as may be gathered from the subsidiary findings of the Master (R. 636, 638, 639, 640), which his ultimate finding ignores (R. 637). Cf. *United States* v. *Esnault-Pelterie*, 303 U. S. 26, 31: The conclusion follows as well as from the testimony of respondents' own agent (R. 1368–69, 1434–36).

[9] There can be no question of minimizing the conflict of decisions on the basis of *Erie R. R. Co.* v. *Tompkins*, 304 U. S. 64, for the interpretation of federal contracts is a matter of

United States, 58 C. Cls. 81, points to the same conclusion. Compare *Cohen, Endel & Co.* v. *United States*, 60 C. Cls. 513; *F. Jacobson & Sons* v. *United States*, 61 C. Cls. 420.

3. If the contracts are to be construed as allowing a bonus for savings when in fact there are no real savings, the "bonus-for-savings" provisions in Government contracts are opposed to public policy. If so construed, their purpose can only be to pay an unnecessary and illegal gratuity, or to camouflage such unconscionable profits as those made by respondents here. In either case, the purpose is not one which the courts will countenance. *Hume* v. *United States, supra; J. J. Preis & Co.* v. *United States, supra; Burke & James, Inc.*, v. *United States, supra.* And Government officials cannot consistently with their authority and their fiduciary duties commit their principal to such agreements.

CONCLUSION

It is respectfully submitted that, for the reasons stated, this petition for writs of certiorari should be granted.

FRANCIS BIDDLE,
Solicitor General.

AUGUST 1940.

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federal law. Cf. *Board of Commissioners* v. *United States*, 308 U. S. 343; *United States* v. *National Surety Corp.*, 309 U. S. 165, 169. There is, in any event, no articulated or independent state law on the questions.

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